THE WESTERN BALKANS AND THE EU:
WHAT IS NEEDED FOR A COMMON FUTURE?

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1. INTRODUCTION

It is a great pleasure to be here today and to deliver the second Annual Policy Lecture of the Joint Vienna Institute. I am grateful to the JVI for giving me a platform to share some of my personal views on how the prospects of EU membership for the Western Balkans are likely to evolve.

The JVI is an ideal forum for this discussion as it has been particularly successful in fostering dialogue and knowledge transfer between economic policy makers from market and transition economies. I am told that roughly 20,000 officials from transition economies in Central and Eastern Europe, the Baltic and Western Balkan countries and other parts of the World have been trained at the JVI since 1992. This is an impressive figure. Many of these officials have come from former, actual or potential EU candidate countries and have contributed directly to the preparation of their countries for accession to the EU. The JVI has thereby made a valuable contribution to strengthening the administrative capacity of our new or future Member States. This has helped make accession happen and make it a success.

Today I am going to speak about a common future for the Western Balkans and the European Union. That the future for the Western Balkans holds the prospect of eventual EU accession is widely acknowledged and has been mentioned on several occasions, for example by the European Council in Feira in 2000 and the EU–Western Balkans Summit in Thessaloniki in 2003. My subject today is the path towards this goal. What does it take to build a common future for the Western Balkans? I will put forward some preliminary, personal answers to this question.

First, I would like to revisit the current status of previous enlargement rounds, looking at how the process typically unfolds and drawing lessons for future enlargement rounds. I will then try to evaluate the impact of future enlargement rounds, with a focus on the Western Balkan countries, while highlighting what I perceive to be the main differences from the latest wave of enlargement. Building a common future for the Western Balkans and the EU requires effort from both sides. Therefore, the second part of my presentation will deal with the following two issues: firstly, the support that the EU has offered to the Western Balkan countries so far and what more they can expect from us as they get closer to EU accession, and secondly, the policy responses needed from them to facilitate the journey to the EU.

1. THE SUCCESS OF PREVIOUS ENLARGEMENTS

Let me start by taking stock of the achievements of the enlargement process and in particular of its most recent rounds. On 1 May 2004, ten countries and around 75 million people joined the EU, followed on 1 January 2007 by two more countries – Bulgaria and Romania – and their close to 30 million citizens. This fifth enlargement wave was the largest ever in terms of number of countries and population acceding to the EU. It was also the most complex enlargement, as it brought countries into the EU which had experienced very different economic, social and political developments. But what all the new Member States except Cyprus and Malta share, along with the

Western Balkans, is the common legacy of a transition to a market economy. This makes it only natural to assess the EU accession process in the Western Balkans against the background of the latest enlargements – though as the accession of Bulgaria and Romania is too recent to be adequately assessed, I will refer mostly to the accession of the ten new Member States, the so-called EU-10, in May 2004.

The economic implications of this enlargement were examined extensively in the run-up to the May 2004 deadline. Studies ahead of accession predicted a significant boost of economic growth for the new Member States, from 1.3 to 2.1% additional GDP growth per year. The old Member States were also expected to benefit, but to a lesser extent, due to the small economic size of the newcomers – who represented around 5% of the total GDP of the newly enlarged 25-member EU. Possible effects that could create temporary adjustment pressure, such as migration flows, relocation of activity and downward pressure on wages in the old Member States, were expected to be contained and transitory.

Two years after the May 2004 enlargement, the European Commission carried out a comprehensive study[1] assessing the economic dimension of enlargement. This study, in short, confirmed that the favourable economic expectations had broadly materialised:

- The new Member States have undertaken extensive modernising reforms and are now dynamic market economies;
- Trade and investment has multiplied between the EU-15 and the EU-10, as well as among the EU-10, creating a win-win situation for all involved;
- This has opened new opportunities for business in the EU-15, helping them to stay competitive in the face of a challenging global environment;
- Overall, the latest enlargement has led to a more integrated internal market and thereby created conditions for the whole European economy to become stronger and more dynamic, and hence better equipped to face stiffer global competition.

I suggest that we now take a closer look at the advantages to growth and stability brought about by the deeper integration of the new Member States in the EU economy. Economic growth was, on average, faster in the new than in the old Member States in the run-up to and around accession – 3.8% per year in the new Member States against 2.5% in the old in 1997-2005. This catching-up process saw the EU-10 average income rise from 44% of the EU-15 level in 1997 to almost 55% in 2006. Indeed Slovenia and the Czech Republic have already overtaken Portugal, the country which currently has the lowest per capita income in the former EU-15.

In general, countries with the lowest initial per capita incomes have tended to grow the fastest, and the strong economic performance has also improved their labour market situation. After a long period of decline, employment stabilised in 2004 and expanded by about 1.5% in 2005.

[1] "Enlargement, Two Years After", a study by the Bureau of European Policy Advisors and the Directorate General for Economic and Financial Affairs, Occasional Paper, No. 24, 2006.

The policy lessons from the convergence experience are obvious: macroeconomic and structural reforms have clearly paid off. Macroeconomic stability has progressed as a result of several factors. The application of the EU-wide economic policy coordination and budgetary surveillance procedures to the new Member States has reinforced economic policy discipline. Inflation and interest rates in the new Member States have come closer to those of the EU-15, reflecting the overall credibility of economic policy. In most of the EU-10, the stock of public debt is well below that of the EU-15. However, developments in public finances have been less uniform, also reflecting the impact of transition-related reforms. Six of the new Member States joined the EU with government deficits in excess of the 3% of GDP threshold set by the Treaty. However, all of them, with the exception of Hungary, made progress toward the correction of the excessive deficit situation.

In terms of structural change of economic activity, the most striking developments are the increased trade integration, surging foreign direct investment and strong dynamism in the financial sector.

After trade was liberalised through the Europe Agreements signed with each candidate country in the 1990s, a Free Trade Zone was established at the beginning of this decade, covering about 85% of bilateral trade. As a result trade integration has intensified continuously over the past 15 years. The EU-15 share in total EU-10 imports and exports rose from about 56% in 1993 to 62% in 2005. Between 1993 and 2005 the EU-10 market share in EU-15 imports more than doubled, from 5% to 13%.

The presence of foreign firms in the new Member States has grown rapidly since the mid-1990s: the stock of FDI reached over EUR 230 billion in 2005, or 41% of GDP. The old Member States are the main investors, with a share of three quarters of the total FDI in new Member States.

The financial systems in the new Member States are typically small compared to the EU-15, but are expanding rapidly, as the recent surge in credit growth illustrates. Integration has proceeded particularly fast in the banking sector; cross-border investment and foreign penetration rates are now much higher in the banking sector of the EU-10 than in the EU-15. Enhanced competition has resulted in cheaper loans, especially mortgages, in the new Member States. The opportunities in new growth markets and the possibility of broader portfolio diversification are being used extensively by many banks from old Member States. Austria is one of the most striking examples: its banks have around 25% of their assets invested in the EU-10. The Nordic banks are particularly involved in the Baltic States.

The Commission study also found that many of the concerns that were voiced prior to the accession of the new Member States were not realised.

- First of all, the fear of relocation of activities from old to new Member States and consequent job losses is not borne out by the evidence. FDI flows to the new Member States, while of value to the recipient countries, have in fact been only a minor part of the overall FDI outflows of the EU-15. Recent research for some EU-15 countries suggests that a mere 1–1.5% of the annual job turnover can be attributed to relocation, and only a small part of that to relocation to the new Member States.

- A second area of concern was migration. But migration flows from the EU-10 have in general been small, even to countries that already allow unrestricted movement of workers[2]. There have been no substantial disruptions of recipient national labour markets. Rather, migrant workers have complemented the existing skill base of the EU-15 labour markets and increased the economic potential of the old Member States.
- Thirdly, the agriculture sector of the EU-10 was initially identified as a major challenge. But since accession it has embarked on a successful process of modernisation and catching up. The latest wave of enlargement led to a large increase in the EU's agricultural area (by up to 25%) and the number of farmers (by more than 50%) which needed to be accommodated within the EU’s Common Agricultural Policy. Agricultural productivity in the new Member States is considerably lower than in the EU-15 and the income gap correspondingly large. However, inflows of FDI and EU support have helped to modernise agriculture, increase the animal stock and raise farmers' income in the EU-10. Between 1999 and 2004 agricultural trade almost doubled both among the EU-10 and between the EU-10 and the EU-15, while direct income payments substantially increased farmers' real incomes.

These trends are impressive proof that the latest enlargement acted as a catalyst to enhance economic dynamism and speed up modernisation in the European Union. Most importantly, it is helping the economies of both old and new Member States better face the challenges of globalisation.

Ladies and gentlemen, I have presented this success story for two reasons: first, because I want to emphasise the positive economic effects of previous enlargement rounds, which the public sometimes questions; and second, as a preliminary to discussing the question of whether the same success story can be repeated as the Western Balkans are integrated into the EU. But to answer that question we need to determine what the prerequisites for that success are and try to replicate them for future enlargements.

2. NEXT ROUNDS OF ENLARGEMENT

The EU has made clear where it sees the next rounds of accession taking place, namely in those countries which are already identified as candidates and potential candidates. As you know, Croatia and the former Yugoslav Republic of Macedonia are already candidate countries, and, with the former, accession negotiations are already ongoing. The potential candidates are the other Western Balkans. The distinction between the two groups is a question of how far a country has progressed towards meeting the accession criteria or not. Once these are met, a country is invited to join – but the

[2] Even migration to the UK, although larger than to any other Member State, was overall modest in size: total (cumulative) immigration from new Member States amounted by the end of 2006 to an estimated (upper estimate) of 500 000. This represents less than 1.7% of the UK's total active population.

group of the potential candidate countries in particular still has some way to go before reaching that point.

The speed of accession is determined by how quickly countries meet the political and the economic accession criteria. Although I won't go into them in depth here today, the political criteria play a prominent role, and that is as it should be. They are the concrete expression of the shared values which are the foundation of the EU. The one key preliminary political step required in order to embark on the path towards accession is the conclusion of a bilateral agreement with the EU, the so-called Stabilisation and Association Agreement. And while this may require some domestic political negotiation for certain governments in the region, these political criteria are a sine qua non for the process to begin. They require countries to ensure stability of institutions guaranteeing democracy, rule of law, protection of human rights and respect for and protection of minorities. Any delays in meeting them endanger the overall process of accession.

Having thus touched briefly on the political aspect, let us return to the economic criteria for accession. The two basic criteria are first, that applicants must establish a functioning market economy and second, that they must be in a position to withstand competitive pressure in the Union.

Meeting these basic criteria requires determination and time. The recently acceded Member States have proved that this is possible and decisive in preparing their economies for membership.

The success of the latest round of enlargement was a unique combination of genuine national transition efforts and strong political guidance by the EU, coupled with technical and financial assistance; all of which was reinforced by the rapid rise in international market confidence in the irreversibility of the transition process.

Can this successful model of transition – national reforms combined with market integration and EU assistance – serve to guide the Western Balkans? Can, or will, it be repeated?

Certainly, many building blocks for a successful repetition are in place. Reforms have started and are progressing in many of the countries, integration with their EU neighbours is deepening and the Union is continuing to provide a strong anchor for them in the face of their challenges. I will come back to the role of the EU in this process in more detail later.

But we have to admit that there are also some additional hurdles for the countries in the Western Balkans which may make it more challenging for them to repeat the Central and Eastern European success story, despite the fact that the economic starting point for the transition is by no means worse. These challenges are well known and here let me therefore just briefly touch upon five of them:

- First, there has been a very difficult process of redefining the role and boundaries of states in the region. Armed conflicts are behind us, but we are still far from seeing all problems solved; tensions between and within countries persist, and political stability seems still fragile. In addition, the various newly created states still have to grow into their role of providing an effective framework for peace and a well-functioning economy.

- Second, comparatively good economic starting conditions, as seemed to be the case in ex-Yugoslavia during the 1970s and 80s, can sometimes make it more challenging to reach a consensus in society for market-based reforms. This seems paradoxical, as the more market-based instruments in ex-Yugoslavia had made a higher standard of living possible than in the former COMECON countries. But the pain of transition-related reforms seems to be less well accepted by the population, particularly of course by the temporary losers from reform.

- Third, the quality of public sector governance and the process of institution building are less advanced in the Western Balkans. Not only does this curtail the growth potential of these economies; it also adds to macroeconomic and financial stability concerns, against the background of high and volatile capital flows to emerging markets in general and to the Western Balkans in particular. Weaknesses in the supervisory and judicial framework reduce the resilience of domestic financial systems. This requires increased vigilance with regard to rapid credit expansion or large external imbalances.

- Fourth, the countries in the region might not benefit to the same extent from economic integration, be it FDI or trade, as we have seen in Central and Eastern Europe. The reasons are geography and size. As the Western Balkans are somewhat more remote from the core markets of Western Europe, the trade and investment effects can be expected to be less pronounced in the region. The relatively small size of the economies is also likely to play a role. Potential foreign investors face very small host markets. The bulk of investment is therefore more likely to go into exports, and hence good supply-side conditions, particularly in the labour market, will be even more important.

- And fifth, globalisation has advanced since the mid-nineties, when Poland or the Czech Republic were able to successfully compete for EU investment. East Asia and other parts of the world offer an increasingly attractive alternative, and may partly leapfrog the Western Balkans in attracting EU-based investors or traders. This makes the potential of FDI as a driver of economic development for the Western Balkans less clear-cut.

But, ladies and gentlemen, it is not just for the Western Balkans that the prospect of accession creates challenges, but also for the EU, where the challenges are political.

3. THE EU'S "INTEGRATION CAPACITY"

There has recently been a great deal of intense debate about the conditions of or limits to further enlargement of the EU. Some commentators have jumped to the conclusion that the EU wants to get out of its commitments to the Western Balkans and refuse any further accession. In principle, this discussion is not new. The capacity of the EU to absorb new Member States has been enshrined as one of the criteria for new enlargements since as far back as 1993.

In this debate, some underline the strategic significance of enlargement for peace and democracy in Europe. Others emphasise internal problems which reduce our capacity to integrate new members. Of course both views have merit.

But they must be reconciled so that we can develop a renewed consensus on enlargement and advance in a way that is mutually beneficial. We must keep up the strategic mission of enlargement by maintaining the EU's soft power of democratic and economic transformation and extend the zone of prosperity, peace and liberty. But we must also continue to ensure our capacity to function, at the same time as gradually integrating new members.

How can we achieve that?

First, I believe that regaining economic dynamism in the EU, in particular in the old Member States, is an important precondition for increasing the Union's integration capacity and public support for future enlargement rounds. The comprehensive structural reforms that are being pursued by Member States under the revamped Lisbon strategy will enhance the EU's growth potential and consolidate the good economic results from 2006.

However, the European Union must also look at its own governance and adjust it to the new realities where necessary. The Constitution is an attempt to advance in this respect. And the German Presidency has embarked on an ambitious work plan towards renewed consensus. But what the outcome will be is not yet clear. What *is* clear is that some streamlining of decision-making procedures is indispensable in a growing Union.

We are also trying to improve the quality of the accession process. We will make impact assessments of accession on key policy areas and evaluate budgetary implications for key policies, in particular on agricultural and cohesion policies.

Finally, candidate or potential candidate countries can do a lot to change perceptions and make it easier for the population in today's EU to accept new members. The key here is to continue to make progress in establishing peaceful, democratic, well governed and prosperous countries.

4. COMMUNITY SUPPORT FOR FUTURE ENLARGEMENT HAS BEEN STEPPED UP

The European Union has played and continues to play an important role in stabilising and reforming Europe's transition economies. This is the case for past and for present candidate and potential candidate countries.

Economic developments in these countries have been shaped and advanced by

- the EU model, the *acquis*, as an important blueprint for regulatory and institutional reform;

- technical and financial assistance to the countries, which has helped them revamp their regulatory framework and institutions to make them suitable for functioning market economies,
- the accession criteria, as an impartial and pragmatic device to foster transition and reforms; and more generally
- the prospect of accession, as a catalyst for reform and anchor for political and economic stability.

These elements continue to apply. And some of them have been reinforced. Let me mention two examples:

- The EU has upgraded its technical support: Since the beginning of this year, a new instrument, the Instrument for Pre-accession Assistance, or IPA, is in place. By merging various previous instruments into one it streamlines the legal framework and procedures, while broadening the possibilities and increasing the funding. Between 2007 and 2009, IPA will spend around 3.5 billion EUR in the candidate and potential candidate countries. Of these, around 2 billion EUR will benefit the Western Balkan countries.
- We have further deepened our economic co-operation and dialogue. We have invited the potential candidate countries to submit Economic and Fiscal Programmes. These, like the Pre-accession Economic Programmes of candidate countries, are assessed by the Commission and will be discussed in bilateral and multilateral settings. They should help in the process of establishing a domestic economic planning capacity and preparing for eventual participation in the EU's Economic and Monetary Union.

I mention these examples to illustrate that the EU is keeping its doors open to the Western Balkans. We are working together and we are keeping our commitments.

The current Members of the EU will also benefit from enlargement. The entire European Union has a keen interest in bridging the remaining gaps with the Western Balkans and extending our prosperity and stability to the entire region. Even though the region is small compared to the European Union, we have learnt from history the costs of failing in the process of integration. Successful integration, by contrast, brings economic, political, stability and security benefits to the entire continent. This is not an abstract concept; the EU has a direct interest in ensuring that the painful experience of the regional military conflicts in the Western Balkans is not repeated. Moreover, many of our companies are deeply engaged in the region and have a lot to gain or lose from the success or failure of further reform and integration of the Western Balkans.

5. REQUIRED POLICY RESPONSE

Economists know all too well that there is no such thing as a free lunch.

EU support and an open door to the EU are not sufficient in themselves to make either economic prosperity or accession happen. Countries need to press ahead with reforms, stabilisation and institution-building, as I have already mentioned. Their dates of entry into the Union depend solely on the results of their reforms. Each country will be judged on its own merits.

Let me concentrate on economic policy and stress some of the key areas where progress is required:

Macroeconomic stability needs to be further improved in order to create conditions for sustainable growth and sound investment.

The Western Balkans have come a long way in stabilising their economies. High inflation represented the biggest macroeconomic challenge in the early 1990s. Fortunately, this problem disappeared quickly, except in Serbia, where inflation only recently declined to single-digit rates. Nonetheless, fighting inflation remains an ongoing process as we notice that inflationary pressures mounted again in 2005 and 2006, mainly due to strong domestic demand fuelled by rapid credit growth, global rises in commodity prices and increases in administered prices. As the monetary policy instrument was largely relinquished with the adoption of fixed exchange rate regimes, the onus of macroeconomic stability now falls on fiscal and structural policies.

Fiscal consolidation was pursued further in 2005 and 2006 as average deficits came down and several economies recorded small budget surpluses. But this improvement was in most cases facilitated by robust economic growth and may not reflect a structural improvement. The further improvement of fiscal balances throughout the region and especially in Albania, Bosnia and Herzegovina, Croatia and Kosovo is crucial for securing overall macroeconomic stability. External imbalances are high, resulting from strong capital inflows and accelerated financial integration. Governments need to refrain from adding to these.

At present, the Western Balkan economies enjoy relatively easy access to foreign savings as the speed of financial integration has outpaced the real convergence process. This gives them an opportunity to expand their growth potential and dynamics. It is not, however, free from risks. Recent episodes of contagion following financial turmoil in other parts of the world suggest that an over-allocation of abundant foreign resources towards consumption and residential investment can worsen domestic and external imbalances.

Therefore, authorities in the region need to determine whether the current expansion of private consumption, rapid credit growth which is increasingly directed to households and rising external debt are still a natural manifestation of the catching-up process or already warning signs of untenable imbalances. The efficiency and soundness of financial markets and banking systems in the region has not yet been fully tested. Financial supervision and judicial systems need to be further strengthened in order to create a healthy lending environment.

The large-scale involvement of EU banks and financial institutions in the region, together with the widespread restructuring and privatisation of the domestic financial systems, provide some reassurance in this respect. However, the challenges posed by the sheer speed of credit growth and the currency mismatches in the balance sheets of corporates, households and the banking sector remain significant.

In recent years, the Western Balkan economies have witnessed an appreciation of their real exchange rates in terms of consumer prices, but less so in terms of unit labour costs. Although this might be normal to some extent during transition and catching-up, it should serve as a reminder of the importance of preserving external competitiveness in the context of strong capital inflows, fixed exchange rate regimes and fairly rigid factor markets.

This brings me to the next key policy tasks for the Western Balkan economies: raising market efficiency and creating an attractive business environment.

The economic performance in the last three years has been quite good; real GDP has grown by more than 5% per year on average in the region. Yet, there is plenty of scope for more economic catching-up. With the notable exception of Croatia, economic prosperity in the region (in terms of GDP per capita in PPS) has reached only about a fifth of the EU-25 average. Therefore, sustained catching up by raising potential growth is both very much needed and possible.

Creating a more attractive business environment is vital if robust growth is to be generated and sustained. And this in turn requires a sound political and institutional framework. Without further deepening democratic processes and institutions, building a supportive public administration, or ensuring property rights via an independent judiciary system, it will not be possible to sustainably stimulate domestic savings and investment or attract a critical mass of FDI. Moreover, the differences between economies are fairly large, with certain economies like Kosovo and Bosnia and Herzegovina in a rather weaker position.

The Western Balkans should also turn their attention to the public sector. They must make it more efficient and improve its governance. The build-up of democratic institutions and rule of law does not have to entail a large public sector. Currently, public spending in some countries, such as Bosnia and Herzegovina, Croatia, Montenegro and Serbia, appears to be somewhat excessive and inefficiently targeted. Continued efforts to reduce the relative size of government would help create more space for private-sector-led growth.

Accelerating the restructuring and privatisation of state-owned enterprises would also limit government intervention in the economy and boost productivity and income. In recent years, progress on structural reforms has been uneven. A large share of privatisation programmes – except in Montenegro and Serbia where the process started later – are now fairly advanced, although with important enterprises in the telecommunication and utilities sectors still remaining in state hands. The restructuring of energy utilities and markets has only recently begun, reinforced by the signature of the South-Eastern Europe Energy Treaty in October 2005.

Another precondition for increasing the growth potential is to raise the efficiency and flexibility of the labour markets in the region. Registered unemployment rates in 2005 varied between 12.7% in Croatia and around 44% in Bosnia and Herzegovina. At the same time, the average participation rate is about 10% points lower than in the EU-25, although the existence of a large informal sector casts doubt on the accuracy of these figures. Heavy taxation of labour, high dismissal costs and low wage flexibility constrain employment on the official labour market and endanger the long-term sustainability of public finances. The authorities need to take resolute measures to address these issues, including by accelerating reforms in the pension and health-care systems.

6. CONCLUSION

Today, I have tried to convey a few ideas and concepts about our common future, which, by way of conclusion, I would summarise in the following five points:

1. Firstly, the "enlargement miracle" of 2004 and 2007 can be repeated, and I am confident that it will. Citizens of the Western Balkans and citizens of the EU will reap the benefits of all reform efforts under a joint umbrella, the European Union.

2. Secondly, a common effort is necessary for this common future: the EU must continue to provide a strong anchor for the process of reforms in the countries in question and must prepare itself for future enlargements, while countries in the region must press ahead with economic reforms and stabilisation.

3. Thirdly, much has already been achieved: the EU has stepped up its political, technical and financial support for the Western Balkans. And at the same time, the Western Balkan countries are taking measures to enhance macroeconomic stability and strengthen productivity by improving the business environment and unleashing factor markets.

4. Fourthly, these reforms must be embedded in the broader political context of safeguarding peace and liberty in the region, leaving behind the painful legacy of the past.

5. And finally, the EU will not leave the Western Balkans alone on this path. Support will be continued and stepped up, if required. This includes the contribution of my department, DG ECFIN, of the European Commission. Our commitment to that process is absolute.

Thank you very much for your attention.